NOTE

This Microfiche meets the quality requirements of the American National Standard for Microfiche of Documents (ANSI PH5.9-1975). However, because of imperfections in the document from which it was made, it contains images that are illegible or difficult to read. The source document for this microfiche is the best copy that could be obtained prior to filming.

Congressional Information Service, Inc.
4520 East-West Highway
Bethesda, Maryland 20814

APPLICABILITY OF THE NORMALIZATION REQUIREMENTS OF THE INTERNAL REVENUE CODE TO CONSOLIDATED TAX SAVINGS ADJUSTMENTS

Scheduled for a Hearing
Before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
of the
COMMITTEE ON WAYS AND MEANS
On September 11, 1991

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

September 6, 1991

JCX-15-91

J862-27
H782-32

CONTENTS

		Page
INTRODUCTION		1
I.	OVERVIEW	2
II.	PRESENT LAW AND BACKGROUND	4
	A. General Description of Ratemaking for Regulated Public Utilities	4
	B. Methods of Accounting for Federal Income Taxes: Flow-through Versus Normalization	4
	C. Normalization Under the Internal Revenue Code of Tax Benefits Derived From Accelerated Depreciation	8
	D. Consolidated Income Tax Returns	13
III.	CONSOLIDATED TAX SAVINGS ADJUSTMENTS	22
	A. Definition and Examples	22
	B. IRS Ruling Letters	23
	C. Judicial Interpretations	24
	D. Proposed Treasury Regulations	26
IV.	ISSUES CONCERNING THE APPLICABILITY OF THE NORMALIZATION REQUIREMENTS TO CONSOLIDATED TAX SAVINGS ADJUSTMENTS	29

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and discussion of consolidated tax savings adjustments and the normalization requirements of the Internal Revenue Code. The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a hearing on September 11, 1991, on the withdrawal by the Internal Revenue Service of its proposed regulations concerning the treatment of consolidated tax savings adjustments under the normalization requirements of the Internal Revenue Code.

The first part of this document is an overview. The second part provides a brief description of ratemaking for regulated public utilities (including the normalization and flow-through methods of accounting for Federal income taxes), the present-law normalization requirements under the Internal Revenue Code, and the present-law rules regarding consolidated income tax returns. The third part provides a more detailed description of consolidated tax savings adjustments. Part four discusses certain issues arising in connection with consolidated tax savings adjustments and the normalization requirements of the Internal Revenue Code.

---

[1] This document may be cited as follows: Joint Committee on Taxation, Applicability of the Normalization Requirements of the Internal Revenue Code to Consolidated Tax Savings Adjustments, (JCX-15-91), September 6, 1991.

I. OVERVIEW

Utility ratemaking and the normalization requirements

A public utility commission generally allows a utility to collect enough in rates to recover the utility's cost of service and provide a fair rate of return to investors. Federal income taxes are an important factor in determining rates because income tax expense is considered to be a recoverable cost of service and because income taxes that are deferred through the use of tax benefits may represent a no-cost source of capital to the utility. The Federal income tax treatment of an item may differ from the ratemaking treatment of the item (for example, depreciation allowances generally are computed on a more accelerated basis for Federal income tax purposes than for ratemaking purposes). Any tax benefit resulting from this difference may be "flowed-through" to ratepayers (i.e., generally reduce rates for the period that the item is taken into account for Federal income tax purposes) or "normalized" (i.e., generally not taken into account for ratemaking purposes until the period for which the underlying item is taken into account for ratemaking purposes).

Under present law, in order for public utility property to qualify for certain accelerated depreciation allowances for Federal income tax purposes, the benefits of accelerated depreciation must be normalized. Normalization accounting as applied to accelerated tax depreciation generally requires regulatory tax expense to be computed using the depreciation methods and periods used for regulatory, rather than Federal income tax, purposes. Any deferred tax reserve resulting from the use of the normalization method of accounting may be used to reduce the rate base upon which a utility earns its rate of return.

Consolidated tax returns and consolidated tax savings adjustments

For Federal income tax purposes, an affiliated group of corporations may elect to file a consolidated income tax return. One of the advantages of filing a consolidated return is that tax losses from some members of the group may offset all or a portion of the taxable incomes of the other members.

Some utilities with separate company taxable incomes have filed consolidated returns with nonregulated affiliated companies that generated tax losses, resulting in the consolidated Federal income tax liability of the group being less than what the tax liability of the utility would have been had separate tax returns been filed. Some public

utility commissions have attempted to "flow-through" this consolidated tax saving to ratepayers (a "consolidated tax savings adjustment").

IRS rulings and proposed Treasury regulations

In several ruling letters issued during the 1980s, the Internal Revenue Service ruled that the use of a consolidated tax savings adjustment was inconsistent with the normalization requirements of the Internal Revenue Code. Some of these rulings were withdrawn when the IRS opened a regulations project to consider the extent to which consolidated tax savings adjustments violated the normalization requirements. Proposed Treasury regulations were issued in November 1990. According to the IRS, the proposed Treasury regulations met with widespread disapproval from both utilities and public utility commissions. In April 1991, the proposed Treasury regulations were withdrawn "pending Congressional guidance."

II. PRESENT LAW AND BACKGROUND

A. General Description of Ratemaking for Regulated Public Utilities

The rates a regulated public utility may charge its customers for the goods or services it provides generally are established or approved by a public utility commission. In setting utility rates, a public utility commission generally attempts to allow the utility to collect from its customers amounts that are sufficient to: (1) recover operating expenses (the cost of service element), and (2) provide a fair rate of return to investors (the rate of return element). Expenses taken into account in determining the cost of service element include labor, fuel, materials, depreciation on utility plant and equipment, and income tax expense. The rate of return element typically is computed by multiplying: (1) an allowable return (as determined by the public utility commission) times (2) the rate base. The allowable rate of return is generally based on the utility's weighted cost of borrowing plus an appropriate return on equity capital. Rate base represents the invested capital of the utility and generally equals the working capital of the utility, plus the original cost of utility plant and equipment, less accumulated regulatory depreciation, and less the deferred tax reserve, if any (as described below). Thus, Federal income taxes are an important factor in determining the rates a utility may charge its customers because: (1) income tax expense is considered a recoverable cost of service, and (2) deferred income taxes may reduce the rate base to which an allowable rate of return is applied.

B. Methods of Accounting for Federal Income Taxes: Flow-through Versus Normalization

Flow-through accounting

The determination of the amount of Federal income taxes reflected in cost of service and rate base depends upon the treatment of various items that are taken into account differently for Federal income tax and regulatory accounting purposes. Full flow-through accounting generally treats the actual current Federal income tax liability of the regulated utility as the utility's tax expense in determining utility rates. Thus, under flow-through accounting, the tax benefits of accelerated tax depreciation and other similar items are taken into account immediately in determining utility rates (through their effect of reducing current income tax expense). A deferred tax reserve is neither created nor maintained and no adjustments are required to rate base under flow-through accounting because there are no differences in tax expense for Federal income tax and regulatory purposes.

Normalization accounting

In contrast, under normalization accounting,[2] the utility's tax expense for ratemaking purposes is determined by using the regulatory treatment of the underlying item, rather than the treatment of such item allowed under the tax laws. Differences between the tax expense for regulatory purposes and the actual Federal income tax liability of the utility as reported on the tax return for the same accounting period generally are reflected in a deferred tax reserve. The deferred tax reserve represents the cumulative amount of income taxes that the utility has not yet paid to the government, but will pay when the accelerated tax deductions that gave rise to the reserve "reverse" (i.e., when such items are later taken into account for regulatory, rather than tax, accounting purposes).[3] The deferred tax reserve reduces the rate base for purposes of computing the rate of return element because the reserve is considered to be a no-cost or interest-free source of capital to the utility (i.e., it represents a subsidy that is provided by the Federal Government through the Internal Revenue Code (the "Code")).

Example comparing flow-through and normalization accounting

The following example illustrates the differences between flow-through and normalization accounting.

Assume that for Federal income tax purposes a utility may deduct the cost of certain supplies for the year the supplies are acquired (year 1) and that for regulatory purposes the cost of the supplies are taken into account for the year the supplies are consumed (year 2).[4] In addition,

---

[2] It should be noted that for purposes of this discussion, "normalization" refers to a generic method of accounting that may be used to determine the tax expense of a utility for ratemaking purposes and does not refer to the specific normalization requirements of the Internal Revenue Code that relate to the use of accelerated tax depreciation. See the following section for a discussion of the normalization requirements contained in the Internal Revenue Code.

[3] Deferred tax reserves are also maintained by nonutility companies for financial reporting (book) purposes in order to reflect the tax effects of differences between the treatment of certain items for book and tax purposes. See, Accounting Principles Board Opinion No. 11 and Statement of Financial Accounting Standards No. 96.

[4] This example is for illustration purposes only. There is no inference intended as to the proper tax or regulatory

(Footnote continued)

assume that the cost of the supplies is $1,000, the corporate tax rate is 34 percent, and the utility is allowed to earn a rate of return of 10 percent on its rate base. Also, assume that the public utility commission with the authority to establish the utility's rates is undertaking such a determination with respect to both years 1 and 2.[5]

Under flow-through accounting, the cost of the supplies ($1,000) is taken into account as a cost of service for year 2 and acts to increase the rates charged for that year. However, because the cost of the supplies are deducted for Federal income tax purposes for year 1, the benefit represented by this accelerated tax deduction ($340) will reduce income tax expense (and thus, cost of service and utility rates) for year 1 for regulatory purposes. Because the cost of the supplies is treated the same for Federal income and regulatory tax purposes, a deferred tax reserve is not created and no adjustments are made to rate base.

Under normalization accounting, the cost of the supplies also is taken into account as a cost of service for year 2, and is reflected in the rates charged for that year. In addition, the amount of the benefit represented by the tax deduction for the cost of the supplies will reduce income tax expense (and thus, cost of service and utility rates) for year 2 for regulatory purposes.

Because the cost of the supplies is deductible for year 1 for Federal income tax purposes, the amount of tax liability shown on the utility's tax return for year 1 will be less than the tax expense taken into account for regulatory purposes for that year under normalization accounting. That difference creates a deferred tax reserve that reduces the rate base for year 1. The reduction in the rate base reduces the revenue requirement for year 1 by $34 ($340 tax benefit times the 10-percent allowed rate of return). In year 2, the cost of supplies becomes deductible for regulatory, but not Federal income, tax purposes. Thus, the deferred tax reserve "reverses" and is restored to

---

[4] (continued)
accounting treatment of the cost of acquired supplies. In addition, there is no requirement in the Code that the cost of supplies be normalized.

[5] Utility rates generally are not established annually. (However, some States require utilities to make certain periodic filings.) Rather, once utility rates are set, they remain in existence until either the utility or the public utility commission considers that such rates may no longer be appropriate. At such time, administrative procedures (a rate case) are undertaken to reassess or redetermine the rates the utility may charge.

(increases) the rate base for year 2.

Table 1 summarizes the treatment of the cost of the supplies under the flow-through and normalization methods of accounting.[6]

Table 1.--Flow-through and Normalization Calculations

Treatment under	Year 1	Year 2
Flow-through		
Cost of service (supplies)	$ 0	$1000
Cost of service (taxes)	(340)	0
Rate of return	0	0
Total effect on utility rates	($340)	$1000
Normalization		
Cost of service (supplies)	$ 0	$1000
Cost of service (taxes)	0	(340)
Rate of return	(34)	0
Total effect on utility rates	($34)	$660

Thus, under flow-through accounting, with respect to an item for which a deduction is allowed for Federal income tax purposes before the item is taken into account for regulatory purposes (such as accelerated tax depreciation), utility rates are lower for those consumers who are charged for service in the earlier years (relative to those consumers who are charged for service in later years). Under normalization accounting, the tax benefit of an item reflected in cost of service is taken into account for the same period for which the underlying item is taken into account for ratemaking purposes. As a result, utility rates are higher in earlier years and lower in the later years (relative to flow-through accounting). This relative front-loading of rates under normalization accounting is offset, at least in part, by the adjustment to the rate base (and thus, the rate of return element of ratemaking), which causes a reduction of the total amount of rates charged to consumers.[7]

---

[6] The example is clearly oversimplified. For instance, it ignores the "tax-on-tax effect" (i.e., when the revenue requirement of a utility is increased to compensate the utility for Federal income tax expense, that amount must be grossed-up because the amount collected by the utility for tax expense is also subject to Federal income tax without an offsetting allowable tax deduction).

C. Normalization Under the Internal Revenue Code of Tax Benefits Derived From Accelerated Depreciation

In general

In order for public utility property to be eligible for the more favorable depreciation allowances available under the accelerated cost recovery system ("ACRS"), the tax benefits of ACRS must be "normalized" in setting rates charged by utilities to customers and in reflecting operating results in its regulated books of account (sec. 168(f)(2)).[8] For this purpose, public utility property is defined as property used predominantly in the trade or business of the furnishing or sale of: (1) electrical energy, water, or sewage disposal services; (2) gas or steam through a local distribution system; (3) telephone services; (4) other communications services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701); or (5) transportation of gas or steam by pipeline, but only if the rates for such furnishing or sale are established or approved by certain regulatory bodies (sec. 168(i)(10)).

Under present law, the tax benefits of ACRS are considered to be normalized only if certain requirements are

---

[7] In the example above, the effect on rates under flow-through accounting is a net increase of $660 over the two years; under normalization accounting the effect on rates is a net increase of $626. The $34 difference relates to the rate base adjustment made under normalization accounting which acts to compensate ratepayers for the relative front-loading of rates under normalization (as compared to flow-through accounting). Whether an individual ratepayer is economically better off under flow-through or normalization accounting in this example depends on a number of factors, including the ratepayer's relative consumption of utility services during each of the two years and the ratepayer's own discount rate applied to any investment of the first year's savings occurring under flow-through accounting.

[8] Similar rules are provided for certain public utility property placed in service prior to 1981 (the first year that ACRS was applicable) (sec. 167(l), as in effect before the Omnibus Budget Reconciliation Act of 1990). Under the pre-ACRS rules, utilities were required to normalize the differences arising from the use of different methods in computing tax and regulatory depreciation. The Economic Recovery Tax Act of 1981 provided that the tax benefits of ACRS accelerated depreciation, shortened useful lives, salvage value rules, and placed-in-service conventions must be normalized.

(Footnote continued)

satisfied. First, the tax expense of the public utility for ratemaking purposes must be computed by using the same depreciation method that is used in determining depreciation for ratemaking purposes and by using a useful life that is no shorter than the useful life used in determining depreciation for ratemaking purposes (this generally results in depreciation being determined by using a relatively long useful life and the straight-line method) (sec. 168(i)(9)(A)(i)). Second, the difference between the actual tax expense computed using ACRS and the tax expense determined for ratemaking purposes must be reflected in a deferred tax reserve (sec. 168(i)(9)(A)(ii)). The reserve may be used to reduce the rate base for regulatory purposes without violating the normalization requirements. However, in determining the rate of return of a public utility, the public utility commission may not exclude from the rate base an amount that exceeds the deferred tax reserve for the period used in determining the tax expense for ratemaking purposes (Treas. Reg. sec. 1.167(l)-1(h)(6)). Third, the normalization requirements include a consistency requirement (sec. 168(i)(9)(B)).[9]

Consistency requirement

The normalization requirements are violated if, for ratemaking purposes, procedures or adjustments are used that are inconsistent with the normalization requirements of section 168(i)(9)(A) (sec. 168(i)(9)(B)(i)). Inconsistent procedures or adjustments include any ratemaking procedure or adjustment that uses an estimate or projection of the utility's tax expense, depreciation expense, or deferred taxes that is not used with respect to the other two items and with respect to rate base (sec. 168(i)(9)(B)(ii)). The Treasury Department is authorized to issue regulations that prescribe other procedures or adjustments that are to be treated as inconsistent (sec. 168(i)(9)(B)(iii)). When the consistency requirements were added to the Code, the accompanying legislative history stated that the requirements were enacted in order to clarify that certain ratemaking procedures that had been used by the California public utility commission violated the normalization requirements. In addition, that legislative history provided that the

---

[8] (continued)

In addition, certain normalization requirements were imposed for investment tax credits claimed with respect to public utility property (sec. 46(f), as in effect before the enactment of the Omnibus Budget Reconciliation Act of 1990). The investment tax credit was repealed by the Tax Reform Act of 1986.

[9] See the discussion below for a more detailed description of the consistency requirement of section 168(i)(9)(B).

specific authority to issue regulations with respect to the consistency requirement is not intended to limit the authority of the Department of the Treasury to interpret, by regulations or otherwise, any of the Code provisions relating to normalization.[10]

Effect of a violation of the normalization requirements

If the normalization requirements are not met with respect to any public utility property, the property must be depreciated for Federal income tax purposes using the same method that is used for regulatory purposes and a period that is no shorter than the period that is used for regulatory purposes (sec. 168(i)(9)(C)). Thus, if the benefits of accelerated tax depreciation are flowed through to ratepayers, the Code provides that these benefits are no longer available. If, upon an examination of an income tax return of a utility, the Internal Revenue Service ("IRS") discovers that a violation of the normalization requirements has occurred, the IRS will adjust the Federal income tax liability of the utility to reflect the denial of the use of accelerated tax depreciation. Because these adjustments are potentially significant in amount, both utilities and public utility commissions generally take great care to ensure that ratemaking practices do not result in violations of the normalization requirements.

Effect of normalizing the tax benefits of accelerated tax depreciation

The use of an accelerated depreciation method for Federal income tax purposes results in an actual Federal income tax liability that differs from the Federal income tax liability that would have been incurred if the typically slower depreciation methods used for regulatory purposes had been used for tax purposes. In general, for the first few years after property has been placed in service, the Federal income tax liability will be lower than if the regulatory depreciation schedule had been used. The Federal income tax liability will be greater for the later years when the tax depreciation allowances are less than the regulatory

---

[10] H. Rpt. No. 97-827, 97th Cong., 2nd Sess. (1982) and S. Rpt. No. 97-643, 97th Cong., 2nd Sess. (1982).

The Treasury regulations relating to the normalization requirements generally are found under section 167(l) of the Code. Section 167(l)(5) of the Code (as in effect before the Omnibus Budget Reconciliation Act of 1990) authorized the Treasury Department to issue regulations for the application of the normalization requirements. The regulations under section 167(l) generally apply for purposes of the normalization requirements of section 168 of the Code.

depreciation allowances (assuming no change in the tax rate and no further plant additions).

Under normalization accounting, tax expense for regulatory purposes is determined by substituting regulatory depreciation allowances for those deductions actually claimed on the tax return. The use of regulatory depreciation allowances in determining tax expense for regulatory purposes generally results in the spreading of the tax benefits of accelerated tax depreciation over the regulatory life of the property. The legislative history relating to the original enactment of the first normalization requirements for accelerated tax depreciation indicates that the normalization rules were designed, in part, to provide regulated utilities with the same tax incentive to invest in new plant and equipment as is provided to taxpayers in nonregulated industries.[11] If the tax benefits resulting from accelerated depreciation were flowed-through to ratepayers, a utility may have less of an incentive to make such investments.

The normalization of accelerated depreciation for Federal income tax purposes requires adjustments to actual Federal income tax liability to arrive at the regulatory tax expense and adjustments to rate base. The accumulation of the differences between regulatory tax expense and actual Federal tax liability creates a deferred tax reserve that represents expected future Federal tax liabilities. The calculations required to account for the differences in tax expenses using tax and regulatory depreciation are illustrated by the following example.

Example.--Assume that a calendar year regulated utility placed property costing $100 million in service in year 1. For regulatory (book) purposes, the property is depreciated over 10 years on a straight-line basis with a full year's allowance in the first year. For tax purposes, the property is depreciated over 5 years using the 200-percent declining balance method and a mid-year placed-in-service convention.[12] Assuming a tax rate of 34 percent for all years and no salvage value for the property, the annual adjustments to ratemaking tax expense and the deferred tax reserve would be computed as shown in Table 2.

---

[11] H. Rpt. 91-413 (Part 1), 91st Cong., 1st Sess. (1969).

[12] The 5-year tax and 10-year book lives are used for illustration purposes only. In general, public utility property may be depreciated over various periods ranging from 5 to 20 years under the ACRS system. For regulatory purposes, public utility property may, in certain cases, have a useful life of 30 years or more.

Table 2.--Normalization Calculations for Depreciation

(Millions of dollars)

	Year(s):							
	1	2	3	4	5	6	7-10	1-10
Tax depreciation	20	32	19	12	11	6	0	100
Book depreciation	10	10	10	10	10	10	40	100
Timing difference	10	22	9	2	1	(4)	(40)	0
Tax rate	.34	.34	.34	.34	.34	.34	.34	
Annual adjustment to reserve	3.4	7.48	3.06	.68	.34	(1.36)	(13.6)	0
Cumulative deferred tax reserve	3.4	10.88	13.94	14.62	14.96	13.6	0	

As illustrated in Table 2 above, the use of normalization accounting: (1) requires tax expense for ratemaking purposes to be computed using the book depreciation allowances ($10 million per year) rather than the more accelerated tax depreciation allowances and (2) causes tax expense for cost of service purposes to be greater for the first five years of the property's life than if flow-through accounting had been used, and less in the last five years of the property's life. In addition, normalization accounting results in the creation of a deferred tax reserve that grows through the first five years of the property's life and is used to reduce the utility's rate base for those years.[13] The deferred tax reserve is ratably reduced to zero (and is restored to the rate base) over the last five years of the property's life.

The effect of normalization upon the rates the utility may charge its customers (assuming rates are adjusted each year) are as follows: (1) the tax benefits of accelerated tax

---

[13] For example, at the end of five years, the rate base with respect to the property in this example is $35.04 million ($100 million original cost, less $50 million accumulated book depreciation, less the $14.96 million deferred tax reserve). The $14.96 million deferred tax reserve represents the cumulative amount which has been taken into account as tax expense for cost of service purposes (and reflected in the rates the utility was allowed to charge) under normalization accounting, but which has not yet been paid in income taxes to the Federal Government.

depreciation are spread ratably over the 10-year period for cost of service purposes in the same manner that depreciation expense is ratable for book purposes, and (2) the amount the utility collects annually through rate of return decreases as rate base decreases. Compared to flow-through accounting, normalization results in higher rates in the early years of the 10-year period and lower rates in the later years. Because of the rate base adjustment, the total amount of rates over the 10-year period is lower under normalization accounting than flow-through accounting. Finally, the spreading of the tax benefits over the 10-year period results in the level of rates being more constant from year to year under normalization accounting than under flow-through accounting.

D. Consolidated Income Tax Returns

Prerequisites for filing a consolidated return

For Federal income tax purposes, an affiliated group of corporations may elect to file a consolidated income tax return in lieu of each corporation filing a separate income tax return (sec. 1501). An affiliated group is defined as one or more chains of includible corporations connected through stock ownership with a common parent that is also an includible corporation if: (1) the common parent meets the ownership requirements with respect to the stock of at least one other includible corporation and (2) stock meeting the ownership requirements in each includible corporation is owned directly by one or more other includible corporations (sec. 1504(a)(1)).

A corporation meets the ownership requirement with respect to the stock of another corporation if the first corporation owns stock possessing at least 80 percent of the total voting power and value of the second corporation (sec. 1504(a)(2)). For this purpose, "stock" does not include stock that is not entitled to vote, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, has redemption and liquidation rights that are not unreasonable, and is not convertible into another class of stock (sec. 1504(a)(4)).[14] In general,

---

[14] In addition, the Treasury Department has the authority to issue regulations with respect to applying the ownership test, including regulations that treat warrants, convertible obligations and other similar instruments as stock or not stock; that treat stock options as being exercised; that allow for reliance upon good faith determinations of value; that disregard inadvertent deconsolidations by reason of relative changes in the value of different classes of stock; that disregard certain intragroup transfers of stock; and

(Footnote continued)

includible corporations are defined as any corporation, except tax-exempt organizations,[15] life insurance companies,[16] foreign corporations,[17] section 936 corporations, regulated investment companies, real estate investment trusts, and DISCs.

There are no provisions in the Code or the Treasury regulations that prohibit a regulated public utility from electing to file a consolidated return with its affiliates (assuming the requirements described above are met).[18]

Effects of election to file a consolidated return

An affiliated group that elects to file a consolidated return consents to follow the consolidated return regulations (sec. 1501).[19] Under the consolidated return regulations, the taxable income and tax liability of an affiliated group generally are determined as if the members of the group were a single corporation.[20] Among the most important of the consolidated return rules are those that allow tax losses (and tax credits) of one member of the group to offset the taxable income (and the tax liability otherwise arising from the taxable income) of other members of the group.[21] The treatment of the members of a consolidated group as a single

---

[14] (continued)
1504(a)(5)).

[15] Tax-exempt title holding companies may elect to file consolidated returns with similar affiliated organizations (sec. 1504(e)).

[16] Life insurance companies may elect to file consolidated returns with other affiliated life insurance companies. In addition, a life insurance company that has been a member of an affiliated group for five taxable years may be included in a consolidated return with a corporation that is not a life insurance company (sec. 1504(c)).

[17] Certain wholly-owned Canadian and Mexican corporations may be included in the consolidated return if the corporations are maintained solely for purposes of complying with the laws of the foreign country as to title and operation of property (sec. 1504(d)).

[18] Under the Excess Profits Tax of 1950, public utilities were excepted from the definition of includible corporations unless they filed consents to forego special excess profits credits available to utilities. The excess profits tax was subsequently repealed.

However, the Public Utility Holding Company Act of 1935 (15
(Footnote continued)

entity for purposes of computing the group's income tax liability stems, in part, from the theory that although the members of the group are separate legal entities, sufficient ownership and control exist among and between the members as to view them as an economic unit.[22]

Currently,[23] there is only one special rule regarding public utilities or utility property in the consolidated return provisions of the Code and the underlying regulations.[24] This special rule is effective for closing agreements requested before November 16, 1966.

Regulatory authority

If an affiliated group wishes to exercise its privilege to file a consolidated return, each member of the affiliated group that is to be included in the initial consolidated return must consent to the election. Once the election is made, it is binding on all electing corporations as well as includible corporations that subsequently enter the affiliated group so long as the group remains in existence. The election generally may be withdrawn only with the consent of the IRS (Treas. Reg. sec. 1.1502-75).[25]

---

[18] (continued)
U.S.C. sec. 79) may prevent certain public utilities (generally gas or electric utilities) from being owned by an nonregulated parent holding company. This Act may operate to prohibit or place restrictions on the formation of certain affiliated groups otherwise eligible to file a consolidated return, but may not prohibit affected public utilities from entering into other ownership arrangements that qualify for the consolidated return election.

[19] See below ("Regulatory authority") for a discussion of the Treasury Department's authority to issue consolidated return regulations.

[20] Some of the consolidated return rules treat each member of the group as a separate entity. For example, each member of the group generally may elect its own accounting methods in determining its separate taxable income (Treas. Reg. sec. 1.1502-17(a)). The separate taxable incomes of the members of the group are aggregated (and adjusted for certain consolidated items) in order to arrive at the group's consolidated taxable income (Treas. Reg. sec. 1.1502-11).

[21] The regulations provide rules that limit the use of losses, deductions, and credits of a member that arose before that member became part of the affiliated group (e.g., Treas. Reg. secs. 1.1502-3(c), 1.1502-4(f), 1.1502-15, 1.1502-21(c),
(Footnote continued)

An affiliated group may file a consolidated return only if each member of the group consents to all of the consolidated return regulations (sec. 1501). The Treasury Department is authorized to prescribe all necessary regulations so that the tax liability of the affiliated group and each corporation in the group (both during and after affiliation) may be returned, determined, computed, assessed, collected, and adjusted in such a manner that clearly reflects the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability (sec. 1502). Finally, in the case of a consolidated return made or required to be made, the tax is to be determined, assessed, collected, and adjusted in accordance with the regulations under section 1502 before the last day prescribed for the filing of such return (sec. 1503).

The exercise of the broad powers described in sections 1501, 1502, and 1503 result in what are known as "legislative regulations."[26] These regulations generally are given the force and effect of statutory law.[27] Some commentators have stated that the broad powers granted to the Treasury Department in sections 1501, 1502, and 1503 are further enforced by Congress' failure to legislate in detail in the

---

[21] (continued)
and 1.1502-22(c)). In addition, Code sections 1503(c), (d), and (f) place limitations on the use of certain losses of life insurance companies, dual consolidated losses, and losses allocable to subsidiaries that pay preferred stock dividends, respectively.

[22] "(T)he principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and to the Government." S. Rpt., No. 617, 65th Cong., 3d Sess. 9 (1918).

[23] The Revenue Act of 1942 imposed a 2-percent surtax on corporations filing a consolidated return. Regulated public utilities were excepted from the surtax by the Internal Revenue Code of 1954. The 2-percent surtax was repealed by the Revenue Act of 1964.

[24] Generally under the consolidated return regulations, if one member of a consolidated group sells depreciable property to another member, any gain on such sale is deferred, the acquiring member takes a cost basis in the property, and the deferred gain is restored to income as the property is depreciated by the acquirer (Treas. Reg. secs. 1.1502-13 and 1.1502-31). The special rule applicable to certain utilities provides that an affiliated group and the IRS may enter into a closing agreement that ignores the general rules on
(Footnote continued)

area. It is further suggested that the lack of statutory provisions is due to the overall complexity of consolidated returns and the burden that would result in amending consolidated return statutory provisions whenever corresponding changes were made to the statutory provisions affecting corporations.[28]

Tax allocations

The term "earnings and profits" generally is used as a measure of the economic profit of a corporation for Federal income tax purposes,[29] but such term is not defined by the Code or the accompanying regulations.[30] The earnings and profits of a corporation generally are determined by adjusting the corporation's taxable income to reflect the differing treatment of certain items. One such adjustment relates to Federal income taxes, which reduce earnings and profits, but are not deductible for purposes of determining taxable income.

The earnings and profits of a member of a consolidated group are first determined on a separate company basis (Treas. Reg. sec. 1.1502-33). The Code and the consolidated return regulations provide methods for allocating and

---

[24] (continued)
intercompany sales if a regulated utility purchases property from an affiliate pursuant to an arrangement that had a significant effect on the rates the utility may charge and the public utility commission has accepted or approved the accounting for such arrangement. The special rule is effective for closing agreements requested before November 16, 1966 (Treas. Reg. sec. 1.1502-13(j)).

Apparently the special rule was designed to allow certain telephone companies to continue to account for certain acquisitions of property from an nonregulated affiliate in a manner consistent with an arrangement in effect before promulgation of the 1966 consolidated return regulations. See, Fred W. Peel, Consolidated Tax Returns, sec. 13.05 (3d ed.).

[25] See Rev. Proc. 91-11, 1991-6 I.R.B. 9, and Rev. Proc. 91-39, 1991-27 I.R.B. 11, for a description of the procedures that taxpayers may follow to obtain such consent.

[26] The Treasury regulations under the normalization requirements of the Code may also be considered to be legislative in nature.

[27] "Congress...has given the (Commissioner of the IRS) the power to promulgate regulations which govern all taxpayers
(Footnote continued)

apportioning the Federal income tax liability of a consolidated group among its members for purposes of determining each member's earnings and profits. Section 1552 allows the group to elect, with its first consolidated return, to apportion its Federal income tax liability based on: (1) the relative taxable incomes of the members of the group having positive taxable incomes,[31] (2) the relative separate company tax liabilities of the members of the group having positive separate company tax liabilities, (3) relative taxable incomes, with any increases in tax liability that results from filing a consolidated return allocated based on relative separate company tax liabilities,[32] or (4) any other method selected by the group that is approved by the Treasury Department. The amount of Federal income tax allocated to a member of the group is treated as a liability of the member. Any payments among the members of the group pursuant to a tax-sharing agreement or otherwise that are in an amount other than the amount of the liability are treated as a distribution with respect to stock or a contribution to capital, or a combination thereof (Treas. Reg. sec. 1.1552-1(b)(2)).[33]

The four methods described above are known as the "basic methods" and do not allow members of the affiliated group

---

[27] (continued)
who file consolidated returns. Secs. 1501 and 1502. (The) consolidated return regulations are legislative in character with the force and effect of law....Such regulations will be followed and not overruled by this Court unless contrary to the will of Congress." Woods Investment Co. v. Commissioner, 85 T.C. 274 (1985).

[28] See, Fred W. Peel, Consolidated Tax Returns, sec. 5.01 (3d ed.) and Herbert J. Lerner, Richard S. Antes, Robert M. Rosen, and Bernard A. Finkelstein, Federal Income Taxation of Corporations Filing Consolidated Returns, sec. 1.04 (1988).

[29] For example, a distribution by a corporation is treated as a dividend to the recipient to the extent it is out of its earnings and profits (sec. 316).

[30] Section 312 provides rules as to the treatment of certain specific items (such as depreciation, inventory, installment sales, etc.) for purposes of determining the earnings and profits of a corporation.

[31] A failure by a group to make an election with its first consolidated return results in Federal tax liabilities being allocated pursuant to this first method. See Rev. Proc. 90-39, 1990-2 C.B. 365, and Rev. Proc. 90-39A, 1990-38 I.R.B. 28, for a description of the procedures through which
(Footnote continued)

that produce losses or excess tax credits to have those tax benefits reflected for earnings and profits purposes.[34] However, the consolidated return regulations contain "complementary methods" that, when used in conjunction with the basic methods of section 1552, allow an affiliated group to elect to reflect in earnings and profits the tax benefits that loss members of the group contribute to lessen the overall tax liability of the group (Treas. Reg. sec. 1.1502-33(d)). Although complex in application, there are essentially two different complementary methods.[35] The first complementary method allocates all or a portion of the tax benefits contributed by a member in the year the member would have used the benefit itself by filing a separate company return (Treas. Reg. sec. 1.1502-33(d)(2)(i)). The second complementary method allocates all or a portion of the tax benefits contributed by a member in the year the group uses the benefit (Treas. Reg. sec. 1.1502-33(d)(2)(ii)).

Examples.--Assume that P and S file a consolidated return. In year 1, P has $1,200 of income and S has a loss of $200, resulting in a consolidated taxable income of $1,000 and a consolidated Federal tax liability of $340. In year 2, P has no income or loss and S has $200 of income, resulting in a consolidated Federal tax liability of $68.

---

[31] (continued)
taxpayers may obtain consent to change its method of allocation.

[32] This method is less significant due to the repeal of the 2-percent surtax for the privilege of filing a consolidated return.

[33] For example, assume that P corporation owns 100 percent of S corporation and that the two corporations file a consolidated return. Further assume that the consolidated Federal income tax liability is $1,500, which, pursuant to section 1552, is equally allocated between P and S ($750 each). If pursuant to a tax-sharing arrangement, S remits $1,000 to P, S will be deemed to have made a distribution with respect to stock of $250 (the amount in excess of the taxes allocated to S). If S remits $400 to P, P will be deemed to have made a capital contribution to S of $350 (the amount of the deemed shortfall). See Rev. Rul. 73-605, 1973-2 C.B. 109, and Rev. Rul. 76-302, 1976-2 C.B. 257, for further examples of the effects of tax allocations and tax sharing arrangements.

[34] For example, assume that P and S file a consolidated return and P has taxable income of $1,200 and S has a loss of $200, resulting in consolidated taxable income of $1,000 and a consolidated Federal tax liability of $340. Under any of
(Footnote continued)

Under the first complementary method, the entire $340 tax liability for year 1 would be allocated to P and nothing would be allocated to S. However, for year 2, the entire $68 tax liability would initially be allocated to S, but because S would have had a net operating loss carryforward from year 1 had separate returns been filed and S could have used such carryforward for year 2, a $68 benefit is re-allocated from P to S. The results of the first complementary method are as follows:

Income taxes allocated to:		P	S
Year 1		$340	$0
Year 2	Initial allocation	0	68
	Re-allocation	68	(68)
	Total for the year	$68	$0
Total for both years		$408	$0

Under the second complementary method, the entire $340 tax liability for year 1 would be initially allocated to P and nothing would be allocated to S. In addition, because S's loss is used in consolidation to offset P's income in year 1, a $68 benefit is re-allocated from P to S. For year 2, the entire $68 tax liability is allocated to S. The results of the second complementary method are as follows:

Income taxes allocated to:		P	S
Year 1	Initial allocation	$340	$0
	Re-allocation	68	(68)
	Total for the year	$408	$(68)
Year 2		$0	$68
Total for both years		$408	$0

Note that in the example above, the total amount of taxes allocated to each member of the PS group is the same on a cumulative basis under either of the complementary methods because S would have eventually used its entire loss on a separate company basis. The cumulative amount of taxes

---

34 (continued)
the basic methods, the entire $340 of tax liability would be allocated to P.

35 In addition, the regulations allow a consolidated group to elect any other method with prior approval by the Treasury Department (Treas. Reg. sec. 1.1502-33(d)(2)(iii)).

allocated to each member is equal to the product of its cumulative income and the tax rate ($1,200 times 34 percent in the case of P and $0 times 34 percent in the case of S). Thus, the only difference between the two complementary method relates to timing. Under the second method, S is credited for the use of its tax loss as soon as P uses it. Under the first method, S is not credited for the use of its tax loss until the time S could have it used it on a stand-alone basis. Thus, under the first method, P may be viewed as having "borrowed" the use of loss until year 2 (the time when S could have used it itself).

III. CONSOLIDATED TAX SAVINGS ADJUSTMENTS

A. Definition and Examples

Utilities may file consolidated returns with nonregulated, nonutility affiliates that generate tax losses (or tax credits) that reduce the Federal income tax liability of the affiliated group below the amount that the utility would have paid had it filed a separate company return. The difference between the amount of tax the utility would have paid had it filed a separate company tax return and its allocable share of the group's consolidated tax liability is known as the "consolidated tax savings."

Example.--Assume that a regulated public utility files a consolidated tax return with a wholly-owned nonregulated subsidiary. The utility has separate company taxable income of $110 million and its subsidiary has a separate company taxable loss of $10 million, resulting in consolidated taxable income of $100 million and a consolidated Federal tax liability of $34 million. If separate company tax returns had been filed, the utility would have had a Federal tax liability of $37.4 million, and the subsidiary would have had no Federal tax liability and a net operating loss carryforward of $10 million. In this case, the tax savings resulting from filing a consolidated return is $3.4 million ($37.4 million less $34 million).

Some public utility commissions have attempted to reduce the rates a utility may charge by reflecting consolidated tax savings in the amount of tax expense taken into account for ratemaking purposes (the "consolidated tax savings adjustment").[36] Referring to the example provided above, a

---

[36] Alternatively, some public utility commissions have attempted to reflect consolidated tax savings by computing tax expense by using the effective tax rate of the group rather than the Federal statutory corporate income tax rate. The effective tax rate is determined by dividing the group's tax liability by the sum of the taxable incomes of the members of the group that had positive taxable income. This rate is then applied to the separate company taxable income of the regulated utility to compute its income tax expense for ratemaking purposes. The effective tax rate adjustment operates to reduce income tax expense for ratemaking purposes in much the same way as a direct consolidated tax savings adjustment.

Referring to the example provided above, the effective tax rate is approximately 30.91 percent ($34 million divided by $110 million). This rate is then applied to the separate

(Footnote continued)

public utility commission could attempt to effectuate a consolidated tax savings adjustment by taking $34 million (rather than $37.4 million) into account as tax expense for ratemaking purposes.

B. IRS Ruling Letters

In several ruling letters issued during the 1980s, the IRS ruled that using a consolidated tax savings adjustment to reduce income tax expense for cost of service purposes violated the normalization requirements.[37] In addition, the IRS has ruled that reducing the rate base by a consolidated tax savings adjustment also violated the normalization requirements.[38] In these rulings, the IRS reasoned that consolidated tax savings adjustments violated the normalization requirements because such procedures introduced a variable that served to reduce the deferred tax reserve required under normalization.

In addition, the rulings stated that consolidated tax savings adjustments achieved, through current tax expense, a reduction that would violate the normalization requirements if achieved through a reduction in deferred tax expense. The effect was held to be equivalent to a partial flow-through of the benefits of accelerated depreciation. Finally, some of the rulings stated that the procedures violated the consistency provisions of the normalization requirements because the consolidated tax savings adjustments improperly included transactions of nonregulated affiliates in determining tax expense for ratemaking purposes without giving consideration to such transactions for other ratemaking purposes. That is, the consolidated tax savings adjustments acted to reflect, in rates, the tax benefits of losses of nonregulated affiliates while the losses themselves were not reflected in rates.

---

[36] (continued)
company taxable income of the utility to determine the amount of tax expense to be taken into account for ratemaking purposes (in this case, 30.91 percent times $110 million results in tax expense of $34 million). If the Federal statutory corporate income tax rate had been used, tax expense for ratemaking purposes would have been computed as $37.4 million (34-percent statutory tax rate times $110 million).

[37] See, for example, ruling letters 8525156 (March 29, 1985), 8643052 (July 29, 1986), 8711050 (December 15, 1986), and 8801041 (October 10, 1987). A ruling letter is only directed to the taxpayer who requested it and may not be used or cited as precedent.

[38] Ruling letter 8904008 (October 24, 1988).

The IRS revoked some of the previously-issued ruling letters in conjunction with the opening of a regulations project that was to provide guidance as to the proper application of the normalization requirements for public utilities filing consolidated tax returns.[39] Specifically, the regulations were to address whether the use of consolidated tax savings adjustments violated the normalization requirements.[40]

C. Judicial Interpretations

Several courts have considered the issue of the proper treatment of consolidated tax savings adjustments for ratemaking purposes. In Federal Power Commission v. United Gas Pipe Line Company,[41] a regulated gas pipeline company filed a consolidated tax return with nonregulated affiliated corporations that generated income tax losses on a separate company basis. The Federal Power Commission (FPC), which regulated the pipeline, applied a ratemaking formula that: (1) applied the losses of the nonregulated members against the income of other nonregulated members, (2) applied any remaining losses to reduce the taxes of the regulated members, and (3) allocated the consolidated tax among the regulated members in proportion to their taxable income. The FPC did not reflect the losses of the nonregulated affiliates in rates. The United States Supreme Court held that the FPC did not exceed its statutory authority in applying its consolidated tax savings formula even though the operations of the nonregulated members were not taken into account for ratemaking purposes. The Court stated that the FPC had the power and duty to limit cost of service to actual expenses. Furthermore, the Court held that the use of the formula did not frustrate Federal tax laws because the affiliated group that included the pipeline company may continue to file consolidated returns and offset taxable income from some members with losses of other members. Finally, the Court held that through use of the formula, the FPC did not appropriate or extinguish the losses of the members of the affiliated group.[42]

---

[39] See, for example, ruling letters 935009 and 8935010 (May 26, 1989), revoking ruling letters 8711050 and 8643052, respectively.

[40] See Notice 89-63, 1989-1 C.B. 720, describing the regulations project.

[41] 386 U.S. 237 (1967).

[42] It should be noted that United Gas Pipe Line Company was decided in 1967, two years before the enactment of the original normalization requirements. In addition, it is

(Footnote continued)

Likewise, several State courts have concluded that State public utility commissions may take consolidated tax savings into account for ratemaking purposes.[43] Most of these cases were decided before the issuance of the ruling letters described above.

However, in Continental Telephone Company of Pennsylvania v. Pennsylvania Public Utility Commission,[44] the Pennsylvania State court upheld the authority of a State public utility commission to make a consolidated tax savings adjustment despite the fact the utility before the court had received a ruling letter from the IRS that held that such an adjustment would constitute a violation of the normalization requirements of the Code. The court stated that the ruling letter "although a statement of the position of its author and perhaps the IRS as a whole, is not controlling."[45] Further, the court held that the ruling did not rest "upon compelling law and logic."[46] Specifically, the court analyzed the normalization requirements of the Internal Revenue Code that were cited in the ruling and concluded that normalization applied only to the tax benefits generated by the accelerated depreciation of public utility property and did not extend to the tax benefits generated otherwise. Thus, the court concluded that because the proposed consolidated tax savings adjustment did not affect the calculation of the required deferred tax reserve, the normalization requirements of the Code were met.

The proper ratemaking treatment of consolidated tax

---

42 (continued)
understood that the Federal Energy Regulatory Commission (FERC), the successor to the FPC, no longer applies a consolidated tax savings formula in determining rates. See, City of Charlottesville v. FERC, 774 F 2d. 1205 (DC Cir. 1985), cert. denied, 475 U.S. 1108 (1986).

43 See, for example, Michaelson v. New England Telephone and Telegraph Company, 404 A.2d 799 (R.I., 1979); Chesapeake and Potomac Telephone Company of Maryland v. Public Service Commission of Maryland, 187 A.2d 475 (Md., 1963); Mechanic Falls Water Company v. Public Utilities Commission, 381 A.2d 1080 (Maine, 1977); The Mountain States Telephone and Telegraph Company v. The Public Utilities Commission of Colorado, 576 P.2d 544 (Colo., 1978); and United Inter-Mountain Telephone Company v. Public Service Commission, 555 S.W. 2d 389 (Tenn., 1977).

44 548 A.2d 344 (Pa. Commw., 1988).

45 Id. at 351.

46 Ibid.

savings adjustments have also recently been considered by a Texas State court. In Public Utility Commission of Texas, et. al. v. General Telephone Company of the Southwest,[47] a Texas court of appeals remanded a rate order to the State public utility commission to ensure that a consolidated tax saving adjustment was taken into account in setting rates. The court held that Texas law requires that "the (c)ommission must therefore: (1) compute the utility's federal income tax expense on a consolidated return basis when doing so yields a tax savings; and (2) impute to the utility a 'fair share' of those savings."[48] A consolidated tax savings adjustment may be imputed even if the utility and its affiliates did not elect to file a consolidated tax return.[49] The court further held that the precedents it relied upon did not contradict the normalization requirements of the Code.[50]

D. Proposed Treasury Regulations

Procedural aspects

In December 1988, the IRS opened regulations project PS-107-88 to provide guidance on the proper application of the normalization requirements to public utilities filing consolidated returns, and to address the issues presented by

---

47 Court of Appeals of Texas, No. 3-90-084-CV (June 19, 1991).

48 At p. 28.

49 The court primarily relied upon the Texas Supreme Court case of Public Utility Commission of Texas v. Houston Lighting & Power Company, 748 S.W. 2d 439 (Tex. 1987). In Houston Lighting, the State utility commission determined that certain costs incurred by the utility in investing in a nuclear power plant were imprudent and should not be taken into account for ratemaking purposes. (Costs that are not allowed for ratemaking purposes are said to be taken "below-the-line.") However, the court held that any reduction in the utility's Federal income tax liability resulting from the tax write-off of the expenses that were not allowed for ratemaking purposes should inure to the benefit of the ratepayers, rather than the shareholders, of the utility. The court in Houston Lighting did not consider whether or not the allocation of the tax benefits from below-the-line costs to ratepayers would violate the normalization requirements of the Code.

50 The court noted that, at the time of its decision, the IRS had withdrawn the proposed regulations that addressed to what extent a consolidated tax savings adjustment violated the normalization requirements of the Code. See footnote 7

(Footnote continued)

consolidated tax savings adjustments. The proposed regulations (which are described below) were published on November 27, 1990. The IRS withdrew the proposed regulations on April 25, 1991.

In its news release announcing the withdrawal of the proposed regulations,[51] the IRS observed that the proposed regulations "met with widespread disapproval." Specifically, the IRS received approximately 100 comments, mostly from regulated utilities and their representatives, as well as some from State public utility commissions, and held a well-attended public hearing on February 8, 1991. According to the IRS, none of the commentators endorsed the basic approach contained in the regulations. The IRS concluded that the proposed regulations would likely be challenged in court.

Finally, the news release stated that Congress has never issued explicit statutory guidance to the Treasury Department or the IRS with respect to the issue of consolidated tax savings adjustments and that the IRS closed the regulations project "pending Congressional guidance."

Substantive provisions of the proposed regulations

The proposed regulations provided that it would be inconsistent with the normalization requirements to determine the income tax expense of a utility for ratemaking purposes by taking into account the tax activity of other members of the utility's consolidated group. Thus, the proposed regulations provided that normalization requires the utility to compute its tax expense for cost of service purposes on a stand-alone, separate company basis. This portion of the proposed regulations was to apply to any rate order that became a final determination after December 19, 1990.

In addition, the proposed regulations provided that it would not be inconsistent with the normalization requirements to reduce the rate base of a utility by an amount not in excess of the utility's share of the cumulative net tax savings attributable to the filing of a consolidated return. However, an exclusion from the rate base was not to be permitted for the utility's share of the consolidated tax saving for any year in which rates were determined under a method that took consolidated tax savings into account in computing ratemaking tax expense. Cumulative net tax savings were to be determined pursuant to the tax allocation provisions contained in Treasury regulation sections

---

[50] (continued)
of the decision.

[51] IRS News Release IR-91-57, April 25, 1991.

1.1502-33(d)(2)(i) and 1.1552-1(a)(2).[52] Those regulations generally provide that losses (and credits) of loss members are allocated, on a pro rata basis, to members that would pay tax on a separate company basis, until such time as the loss members would have used the losses (or credits) themselves (on a separate company basis). This portion of the proposed regulations was to apply to any rate order that became final after the earlier of January 1, 1992, or 30 days after the publication of final regulations.

Thus, the proposed Treasury regulations generally provided that the normalization requirements allowed a consolidated tax savings adjustment to be reflected for purposes of determining rate of return (by way of a rate base adjustment), but did not allow a consolidated tax savings adjustment to be reflected for purposes of determining cost of service for ratemaking purposes.

The preamble to the proposed regulations stated that the proposed regulations did not address the situation where the utility's tax liability is reduced by expenses that are not themselves taken into account in determining cost of service.[53] The IRS invited comments as to the proper treatment of these items under the normalization requirements.

---

[52] See immediately above for a discussion of these regulations.

[53] See, for example, the facts and issues presented by the Houston Lighting case discussed in footnote 49 above.

IV. ISSUES CONCERNING THE APPLICABILITY OF THE NORMALIZATION REQUIREMENTS TO CONSOLIDATED TAX SAVINGS ADJUSTMENTS

In general

With regard to the provision of utility services, public utilities occupy governmentally protected monopoly or quasi-monopoly positions. The government sanction of a limited number of providers of utility services recognizes the economies of scale and the significant capital costs inherent in utility operations. Regulation by public utility commissions is based on the premise that utilities otherwise might take advantage of their positions as exclusive providers of utility services to earn excessive profits at the expense of consumers. The role of utility regulators is to balance the needs of the utility for a fair, relatively predictable rate of return and the interests of consumers in receiving services at reasonable costs in the absence of competitive market forces.

Utility regulators allow utilities to recover their costs and earn a fair return on investment as a means of ensuring continuity of service and reasonable rates for consumers. Elements taken into account for ratemaking purposes consist of costs of service for operating expenses and a return on invested capital. Important issues for utility regulators in determining both of these elements are depreciation allowances for public utility property and the effect of these allowances on tax expense. As described in Part II.C., above, accelerated tax depreciation methods produce larger deductions (and less income tax liability) in the early years of an asset's life and correspondingly smaller deductions (and greater income tax liability) in the later years than the less front-loaded regulatory depreciation methods.

Since Congress enacted the first normalization requirements in 1969, utilities have expanded their activities by investing in nonregulated business ventures or by becoming affiliated with corporations engaged in nonregulated investments. Some of these ventures have involved, for example, the purchase of energy sources and related activities by electric and gas utilities; others have been unrelated to the utility function (e.g., the purchase of financing companies).

If a regulated utility and nonregulated affiliates elect to file a consolidated return and be taxed as a single taxpayer, tax losses incurred by nonregulated members of the group may reduce the tax liability and effective tax rate of the group as a whole. The issue addressed by the recently withdrawn proposed Treasury regulations, described above, was

the appropriate allocation for ratemaking purposes of the tax liabilities and benefits of these consolidated groups among their members, including the regulated utility.[54]

The use of consolidated tax savings adjustments in setting utility rates presents many issues. First, questions arise as to who, the ratepayers or the shareholders (or both), should be entitled to the tax benefits derived from utilities investing in nonregulated activities. Particularly, issues arise as to the source of the funds for these investments. Second, policy questions arise as to the scope of the normalization requirements. Specifically, issues arise as to what extent (if any), the capital formation incentives intended by the normalization requirements (1) are impaired (if at all) by consolidated tax savings adjustments and (2) were intended to extend to property other than public utility property. Third, questions arise as to the technical application of the normalization requirements to consolidated tax savings.

In addition, it has been suggested that the consolidated tax savings adjustment issue may be more appropriately viewed as a consolidated return question, either instead of, or in conjunction with, the normalization requirements.

Finally, although it is understood that the cumulative amount of consolidated tax savings adjustments may be significant throughout the various regulated industries, the staff of the Joint Committee on Taxation has, on a preliminary basis, estimated that any legislative proposal similar to the approach taken by the withdrawn proposed Treasury regulations would not have a significant effect on Federal tax receipts.

Source of funds for nonregulated investments

Some of those in favor of the flow-through of consolidated tax savings argue that the source of the funds for the nonregulated investments of utilities are the rates paid by ratepayers. These flow-through proponents suggest that the present-law normalization requirements result in

---

[54] While not the subject of this hearing, it should be noted that similar issues have arisen with regard to the proper treatment of so-called "below the line" expenses of a regulated utility. These issues involve, for example, whether public utility commissions should be allowed to flow through the tax benefits from items such as (1) charitable contributions a utility may make, (2) direct utility investment in projects qualifying for the low-income housing tax credit, or (3) abandonment losses relating to the costs of plant or equipment that are not allowed to be recovered for ratemaking purposes.

ratepayers paying higher rates than otherwise necessary, and that, therefore, the ratepayers should share in the tax benefits derived from the investment of these funds. A sharing of the tax benefits could be accomplished by allowing public utility commissions to take consolidated tax savings into account when setting rates either through a direct cost of service adjustment, or as allowed under the recently withdrawn proposed Treasury regulations, through a rate base reduction.

Those who are opposed to the flow-through of consolidated tax savings argue that once the rates a utility may charge are set by regulators, any profits realized by the utility are the property of the shareholders and not the ratepayers. These persons reason that a utility (like any other corporation) is free to use these funds for the benefit of its shareholders in any manner as it sees fit. For example, the profits could be distributed to shareholders as dividends or invested in nonregulated business ventures. These persons further argue that when the profits of the utility are used for a nonregulated investment, the risks of the investment are borne exclusively by the shareholders and, therefore, all the rewards, including any tax benefits, accruing from the investment appropriately should inure to the benefit of the shareholders, rather than flow through to the ratepayers. These commentators reason that any attempt to allocate tax benefits of nonregulated investments to ratepayers is equivalent to taking shareholder property for ratepayer benefit. In addition, they argue that flowing through the tax benefits of a nonregulated venture to ratepayers puts the investing utility (and its shareholders) at a competitive disadvantage vis-a-vis an investor that is not rate-of-return regulated.

Scope of protection under the normalization requirements

Those who support the flow-through of consolidated tax savings claim that the normalization requirements of the Code only apply to the tax benefits from accelerated depreciation of public utility plant and equipment and do not extend to other tax or economic consequences (such as filing a consolidated return).[55] Accordingly, they argue that the treatment of these other items is a matter of State ratemaking, as opposed to Federal income tax, policy, and that it should be left to State regulators to decide whether and how consolidated tax savings should be reflected in utility rates.

In addition, the proponents of the flow-through approach

---

[55] This rationale was expressed in the decision of Continental Telephone Company of Pennsylvania v. Pennsylvania Public Utility Commission, discussed above.

suggest that the normalization requirements, when enacted, did not contemplate that the deferred tax reserves created by accelerated tax depreciation and protected by normalization would be used for shareholder benefit or non-utility investment, but rather assumed the use of those funds for future investment in utility property. In this context, these persons point to the substantial diversification of utility and utility-related investment that has developed since the normalization requirements were enacted. In substance, they suggest that the deferred tax reserves are intended to be used for the benefit of ratepayers through future investment in public utility property to enhance or ensure future service. Under this view, benefits from other investments should be viewed as interim to that ultimate use and be shared by the ratepayers.

This argument concludes that the normalization requirements are limited to the protection of Federal capital formation subsidies of public utility property. Supporters of this view suggest that to preclude the flow-through of other tax benefits would require the normalization of all Federal tax benefits, a step that exceeds any legislative directive to date.

Proponents of the flow-through approach argue that the present-law normalization requirements involve the spreading of the tax benefits provided by accelerated tax depreciation over the entire regulatory life of the property and results in the sharing of those benefits between inter-generational users of the property. Thus, they reason that the normalization requirements simply involve timing issues. They argue the consolidated tax savings may involve tax savings that are not necessarily timing in nature, (i.e., that consolidated tax savings may result in the current reduction of the tax expense of the utility's affiliated group but that there is no point at which these savings may be expected to reverse (as in the case of timing items such as accelerated tax depreciation)). Thus, they conclude that it is inappropriate to apply the normalization requirements to consolidated tax savings adjustments.

However, those who oppose the flow-through of consolidated tax savings argue that flowing through these other consequences indirectly defeats the Federal policy of subsidizing capital formation.[56] These persons reason that because final tax liability reflects many factors, any attempt arbitrarily to assign the reason for a lower tax liability to items other than depreciation of public utility property, and to reduce rates to reflect those tax savings,

---

[56] This rationale was expressed in some of the ruling letters (since withdrawn) holding that consolidated tax savings adjustments violated the normalization requirement.

is inappropriate. Opponents of the flow-through approach also argue that to the extent that the loss of an affiliate is attributable to accelerated depreciation deductions, the normalization requirements envision the protection of such benefits, even if the depreciation deductions are claimed with respect to property that is not public utility plant and equipment.

Those who oppose the flow-through of consolidated tax savings also argue that tax benefits other than accelerated depreciation that are provided by Congress for investing in particular activities should not be flowed-through to ratepayers. They reason that this result is necessary to provide the same incentive effect for regulated entities to invest in such activities as is provided for nonregulated entities.

Finally, opponents of flow-through accounting maintain that, in general, normalization accounting is more consistent with generally accepted accounting principles in that normalization does not separate the tax benefits of an expense or loss from the expense or loss itself. They further contend that ratemaking practices and procedures should adhere to generally accepted accounting principles whenever possible. Therefore, they conclude that the benefits of consolidated tax savings should not be separated from the nonregulated loss and flowed-through to ratepayers.

Analysis of the basic approach taken by the proposed Treasury regulations

A key component of the normalization requirements is the consistent treatment of depreciation expense for all elements of ratemaking. The proposed Treasury regulations would have prohibited a direct adjustment to cost of service tax expense as a violation of the normalization requirements. One theory supporting this interpretation is that because the costs incurred in the nonregulated activities are not taken into account as a cost of service, any related tax benefits should likewise be excluded in determining the utility's cost of service.

The proposed regulations would have allowed public utility commissions to exclude from a utility's rate base a portion of the tax benefits from nonregulated investments of a consolidated group. An exclusion from rate base (without a cost of service adjustment) may be viewed as a timing adjustment in that the utility retains the principal element of the tax benefit, but is not allowed to increase rates to include any earnings thereon. In this sense, ratepayers receive some of the timing benefit of the investments, but not the immediate full benefit that a direct cost of service tax adjustment would provide.

Many tax benefits are timing items (as opposed to permanent items), particularly in light of provisions such as net operating loss carryforwards. Some argue that, as with direct depreciation deductions, excluding these timing differences from the rate base may be consistent with the normalization requirements.

On the other hand, it is argued that if a tax benefit reflects a loss that is not timing in nature (as in the case of an affiliate that produces perpetual losses), a rate base adjustment such as the regulations would have allowed may not be consistent with the normalization requirements.[57]

Consolidated return issues

As stated above, some suggest that the consolidated tax savings issue appropriately may be addressed under the consolidated return provisions of the Code, either instead of, or in conjunction with, the normalization provisions. These persons suggest that the tax benefits at issue arise from the privilege of filing consolidated returns, not from the capital formation subsidy protected by the normalization requirements. Accordingly, they reason that disallowing the right to file consolidated tax returns, rather than disallowing the use of accelerated depreciation on public utility property, is the appropriate penalty for any improper accounting of consolidated tax savings.

General policy questions

The privilege of filing consolidated returns allows groups of affiliated corporations to offset the stand-alone tax liability of corporations having taxable income with tax benefits of affiliates. At a minimum, this allows an acceleration of the time when these benefits are realized. In the case of corporations experiencing recurring losses, the privilege may enable them to realize immediately the benefits that otherwise would be deferred for a long period, or that may have expired unused. Regulated utilities typically have positive taxable income, and fewer losses, than many riskier, nonregulated ventures, and thus are attractive affiliates for such other corporations.

Some have suggested that the dual factors of rate regulation and Federal tax provisions such as the normalization requirements, which they reason are intended to benefit ratepayers, create the positive taxable incomes of

---

[57] As a practical matter, it may not be possible to determine at the time a nonregulated affiliate incurs a loss whether such loss will be eventually recovered (i.e., is in the nature of a timing difference) or will never be recovered (i.e., is in the nature of a permanent difference).

utilities and provide an incentive for utilities to consolidate with nonregulated loss corporations. Accordingly, these persons reason that ratepayers should receive a portion of the benefits of consolidation.

On the other hand, others point out that the rules governing the consolidated return privilege do not distinguish between regulated and nonregulated corporations. It is argued that once utility rates are set (taking into account the effects of the normalization requirements), utility profits are shareholder property as are the risks of the investments made with them. Accordingly, these people contend that all benefits of consolidated tax savings appropriately belong to the shareholders. In addition, they argue that placing restrictions on the ability of a public utility to file a consolidated tax return with nonregulated affiliates places such groups at a competitive disadvantage with an affiliated group that does not have such restrictions.

Consistency of application

Consolidated groups of corporations typically have tax-sharing arrangements to allocate their aggregate tax liability among the members of the group. Under these agreements, final utility taxes may not be determined on a stand-alone basis. Some persons suggest that, if utilities are permitted to participate in filing consolidated tax returns and benefit from reduced taxes through these allocation agreements, public utility commissions should be allowed to reflect the resulting tax-benefit transfers for ratemaking purposes as well.

A contrary point of view is that intra-consolidated group tax allocation agreements are merely corporate accounting practices that are not properly reflected in ratemaking because public utility commissions require that utility ratepayers be insulated from the risks associated with nonregulated investments of the group. Because of this segregation of risks, these persons argue that utility taxes properly are determined on a stand-alone basis for ratemaking purposes.

Further, some have suggested that certain regulated utilities are parties to tax allocation agreements that require them to reimburse nonregulated affiliates for any tax benefits allocated to them.[58] Accordingly, there technically may be no benefit to flow through to ratepayers. The tax allocation provisions of the recently withdrawn proposed

---

[58] See, e.g., sec. 12 of the Public Utility Holding Act (15 U.S.C. 79 et. seq.) and 17 C.F.R. 250.45(c), relating to such agreements for covered public utility holding companies.

Treasury regulations would not have recognized these intra-group reimbursements and may have imposed a tax-sharing regime for ratemaking purposes that did not exist in reality.